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Secondary agency conflicts: A synthesis and proposed measurement model

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ABSTRACT

Secondary agency conflicts typically arise when ownership and control are combined in the hands of dominant shareholders who could then seek to misappropriate returns at the expense of minority shareholders. This type of agency conflict has attracted attention from researchers for the past nearly three decades. However, efforts at measuring secondary agency conflicts have been fragmented and scattered. The absence of a coherent and valid approach to assess the scope and intensity of secondary agency conflicts has impeded progress in both empirical and conceptual development of the topic area. Based on a review of the extant body of literature, this paper develops a composite Shareholder Inequity index that measures the potential for secondary agency conflicts employing three different governance dimensions that are grounded in the agency literature: blockholder power, differential control, and the absence of board neutrality. The index is tested and validated empirically using a sample of 748 publicly listed U.S. firms. The resulting Shareholder Inequity index demonstrates high levels of validity and reliability. Future corporate governance studies can utilize this validated measure to investigate potential secondary agency conflicts more consistently and rigorously in order to strengthen organizational theory development and research.

Introduction

Publicly listed companies are often owned by blocks of shareholders who control major portions of equity (Holderness, 2009; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000). These shareholders or shareholder blocks have varying goals and interests (Bagwell, 1992), which may result in conflict when their goals are not aligned with those of other organizational shareholders (Dharwadkar et al., 2000). The conflict resulting from this goal incongruence between dominant and minority shareholders is commonly referred to as secondary agency conflict.[1] Goal incongruence and the resulting conflict becomes

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[1] The terms secondary agency (Singla et al., 2014), type II agency (Villalonga and Amit, 2006), and principal-principal agency (Dharwadkar et al., 2000) have been used interchangeably in the business literature to describe conflicts among firm principals. For convenience and clarity, this study will consistently employ the term secondary agency to define conflicts among various principals. In contrast, primary agency refers to conflicts between managers and owners.

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problematic when a dominant shareholder or shareholder group exercise their control to reap private benefits at the expense of minority shareholders (Barclay and Holderness, 1989; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2002; Villalonga and Amit, 2006, 2009; Young et al., 2008).

Primary agency conflicts have long been studied in the governance literature (Jensen and Meckling, 1976). Once these conflicts were identified, governance solutions to alleviate some of these principal-agent conflicts were put in place. However, these governance mechanisms, designed to reduce primary agency conflicts through enhanced board independence to protect the interests of shareholders, resulted in an unwarranted increase in the levels of conflicts among principals (Ward and Filatotchev, 2010). The focus on secondary agency conflicts is a relatively recent phenomenon. The past two decades have witnessed an increase in publications dealing with secondary agency conflicts (Young et al., 2008). Based on our review of the extant research, the literature has identified three different governance domains where secondary agency conflicts could potentially arise: when ownership is unevenly distributed among blocks of shareholders, when control and power are differentially distributed among shareholders, and when members of the board of directors have direct or indirect ties with powerful shareholder blocks. In addition, prior studies have connected various sub-dimensions of these three secondary agency domains to a host of (typically detrimental) outcomes, such as lower firm valuations (e.g., La Porta et al., 2002), lower dividend payouts (e.g., La Porta et al., 2000), lower investments in innovation (e.g., Morck et al., 2005), and ultimately, expropriation of returns from minority shareholders (e.g., Faccio et al., 2001).

Despite the noteworthy contributions made by these prior studies, extant approaches to measuring secondary agency conflicts have mostly relied on proxy variables and emphasized only unitary domains (viz., predominantly, the size of the largest blockholder) wherein the origins of secondary agency conflicts could potentially reside (for an overview, please see Table 1). Therefore, while these prior approaches have been beneficial in terms of obtaining an overall understanding of secondary agency conflicts, they have been limited in their ability to capture the full range of governance domains and to measure where potential secondary agency conflicts could occur. Furthermore, most studies on secondary agency conflicts have been tied to a specific research context or industry setting (Filatotchev et al., 2011; Renders and Gaeremynck, 2012; Ward and Filatotchev, 2010; Young et al., 2008). As a consequence, these context-specific studies using such partial measurement approaches have inevitably produced incomplete insights, rendering comparisons and integration of findings across different studies problematic and ultimately hampering scientific progress.

Hence, there is a need for an index that inclusively captures all the domain areas from where potential secondary agency conflicts could arise and which measures both the scope and the intensity of these conflicts in a more comprehensive manner. In addition, while there have been limited conceptual efforts at developing such an index in the past, there have been no empirically validated scales to holistically capture secondary agency conflicts.[2] Our contribution is a modest attempt at providing the foundations for such a scale, which is consistent with the emphasis on the adoption of more reliable and valid scales that has been strongly encouraged in strategic management research in order to facilitate construct measurement and theory development (Boyd et al., 2005; Hinkin, 1995; Venkatraman and Grant, 1986). Based on a review of studies dealing with secondary agency conflicts in leading peer-reviewed journals, we develop a comprehensive measure that captures all the governance domains where secondary agency conflicts have been argued to occur. We tested this measure on a sample of 748 publicly listed U.S. firms to establish the validity and reliability of our newly created Shareholder Inequity index.

Our research makes several contributions to the literature and to business practice. First, we provide a validated and comprehensive measurement scale that captures all three governance domains wherein secondary agency conflicts could potentially occur (i.e., blockholder power, differential control, and absence of board neutrality), in order to facilitate meaningful comparisons across multiple studies. Second, we purposefully designed our Shareholder Inequity index to be applicable across a broad range of settings and samples to facilitate the accumulation and integration of knowledge over time. Third, our index provides an aggregated overall score (across all considered domains) regarding the magnitude of potential agency conflicts. Alternatively, the domains can also be disassembled into their individual components for researchers and managers to identify the specific governance areas that are the primary sources of secondary agency conflicts in a sample of firms or even within individual firms.

Finally, managers of firms with different types of dominant shareholders often have to identify and reconcile the divergences in preferences and latent conflicts between multiple shareholder groups. For instance, activist investor groups have in recent times lobbied for the elimination of specific mechanisms like dual class shares since they may exacerbate problems associated with the private benefits of control (Lublin, 2017; Solomon, 2016), as dual class shares insulate the founders and/or dominant shareholder group(s) from the pressure to cater to the concerns and needs of ordinary minority shareholders. The Shareholder Inequity index developed in this paper provides a managerial tool for identifying where latent conflicts may be located and what gives rise to them. It can then enable managers to formulate ways of anticipating or perhaps even eliminating potential conflicts that may emerge in the specific areas of blockholder power, differential control, or absence of board neutrality.

[2] For a noteworthy exception, see the work by Renders and Gaeremynck (2012) who were the first to develop an aggregate agency conflict index that incorporated factors beyond ownership concentration in capturing the severity of secondary agency conflicts. We build on the laudable earlier efforts of Renders and Gaeremynck (2012) by further expanding consideration of the domains where secondary agency conflicts may arise, integrating them into a conceptual framework and empirically testing its validity and reliability.

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